Cutting The Long-Tail: UK Vs. US Insurance Insolvencies

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The universe of U.K. insurers still available to pay long-tail liability claims (e.g., asbestos, pollution and other health hazards) is getting smaller every year. Significant domestic insurers like The Home, Midland and Mission went into receivership in the U.S. years ago. Significant London market companies continue to fade away, depriving policyholders with historic London market policies the opportunity to fully collect upon claims made and satisfied under those policies.

On Oct. 28, a United Kingdom court will hold a hearing regarding whether to approve an amended scheme of arrangement involving certain London market companies that are currently in “run-off” (meaning their only function is to pay claims until their assets are gone). The proposed amended scheme would “crystallize” these companies’ liabilities — a euphemism for “cutting the tail” on their long term exposures by judicial decree. If the amended scheme is approved, a “bar date” will be set after which, subject to certain exceptions, policyholders will not be able to submit new claims against those companies. The particular London companies seeking this new status are The Orion Insurance Co. PLC, Ralli Brothers Insurance Co. Ltd., The London and Overseas Insurance Co. PLC and Hull Underwriters’ Association Ltd. (collectively, the OIC run-off companies).

A crystallized scheme of arrangement can be a good or bad thing for a creditor-policyholder, depending on that creditor’s perspective. A policyholder that has submitted a claim by the bar date stands to collect more, whereas a policyholder that misses the bar date stands to collect less (indeed, usually nothing). What you know and when you know it matters a lot. The main advantage to policyholders is that the claims included in the scheme typically will be paid at a higher value, largely because (1) no funds will be reserved to claims made after the bar date and (2) the administrative costs to manage run-off are less as the company’s affairs wind down at an earlier date than if the company continued in run-off indefinitely. Illustratively, the OIC run-off companies will either pay out all claims in the next two to
three years under a crystallized scheme or the next 20 to 30 years in a run-off. The administrators of the proposed OIC run-off companies scheme say that the difference is likely to be a payout of 71 percent of agreed claims if the scheme runs its course as compared to 78 percent if the amended scheme is sanctioned. This can be a big difference for policyholders with large agreed claims. For those who submit claims before the bar date, another advantage is that claims will be paid earlier maximizing the time value of money paid to them. On the other hand, for the policyholders that miss the bar date — even policyholders with otherwise valid claims under historic London policies — the future is less rosy. If these policyholders miss the deadline, they generally will be paid nothing. In addition, policyholders who are aware of the bar date but do not have valid claims as of that date likewise are out of luck. Some policyholders who submit by the bar date complain that their claims will be undervalued, as circumstances may transform a seemingly small claim into a large one over time. This is not the result policyholders expected when they bought occurrence policies with no deadline for submitting a claim.

There is especial controversy about whether London Insurers should be permitted to crystallize when the companies are solvent. In a solvent scheme, arguably it is the scheme company — not the policyholder creditors — that primarily benefits from the scheme. Unlike an insolvent scheme in which all of the company’s assets are divided among its creditors, in a solvent scheme the company’s assets are sufficient to cover its anticipated liabilities and the surplus goes back to the company’s shareholders. Thus, while policyholders may recover nothing (if they do not submit a claim by the bar date) or an undervalued amount (on future estimated claims), the company’s shareholders retain the funds the company in theory would later owe policyholders. Again, this is not the result for which policyholders bargained and it’s not a result that could occur in a United States insurance run-off.

Under the United States insurance regulatory regime, there is no judicial mechanism by which a solvent insurance run-off operation may “cut the tail” on the carrier’s long-tail liabilities. If there are assets available to pay claims, the run-off continues. There is no shortage of claims administrators and acquisitive insurance groups that are expert at managing run-off operations, using time and distance to squeeze residual shareholder value from a run-off book. But they do so under the watchful eye of U.S. insurance regulators, whose job it is to make sure that policyholder claims get paid first, in full, before equity is returned to the shareholders. As in the U.K., a solvent run-off in the U.S. may eventually evolve into an insolvency. But at that point, the private control over claims administration ceases — and the regulator steps in as a statutory liquidator. Then, and only then, is a bar date set to facilitate an orderly liquidation. And in many states, the regulator (acting as a trustee for policyholders) has the discretion to file an omnibus claim on behalf of legacy policyholders to preserve the ability to pay long-tail liabilities. “Tail-cutting” is rarely, if ever, utilized by U.S. regulators when the only beneficiary of that action is a shareholder. In short, the absolute priority rule — policyholders get paid first, in full, before shareholders get paid — is a powerful and pervading principle in U.S. run-offs and liquidations.

For further discussion of a solvent scheme in the U.K., see the court’s judgment in In the Matter of The British Aviation Insurance Company Limited. Notably, the OIC run-off companies are insolvent and the proposed amended scheme includes an opt-out provision for certain classes of policyholders with claims financially guaranteed by a third party. For more information on the OIC Run-Off Companies scheme, click here.

The takeaway is that policyholders with historic London market coverage need to keep abreast of London companies schemes of arrangement so that they can exercise their rights to vote on the issue (if they seek to sanction or defeat a scheme) or to submit claims, if any, prior to a bar date.

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